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Hong Kong: Looking Toward 1997

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An Intelligence Assessment

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EA 88-10048
December 1988

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Hong Kong: Looking Toward 1997

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An Intelligence Assessment

This paper was prepared by [redacted]
Office of East Asian Analysis. Comments and queries
are welcome and may be directed to the Chief,
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**Hong Kong: Looking
Toward 1997**

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Key Judgments

*Information available
as of 21 November 1988
was used in this report.*

The British and Chinese have made considerable progress toward implementing the 1984 Sino-British Joint Declaration, which sets forth the basic principles for Hong Kong's reversion to Chinese sovereignty on 1 July 1997. We believe their ability to work together has helped in the short run to foster a climate for rapid economic growth, spurred by expanding trade with the mainland.

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Some thorny issues, however, remain that could adversely affect Hong Kong's longer term prospects. We believe the most important is the degree of autonomy Beijing is prepared to grant the city under the so-called Basic Law, the city's future miniconstitution, now under review. A joint Hong Kong-China committee appointed by Beijing has just canvassed public opinion in Hong Kong on a first draft, and the Basic Law Drafting Committee will resume deliberations in January 1989 to consider revisions.

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Local groups have criticized the draft as vague on several key points, in particular for failing to provide adequate safeguards against Chinese interference in the city's internal affairs after 1997 and for failing to provide for the protection of basic civil liberties. Critics also have focused on a plan Beijing appears to tacitly support for selecting a post-1997 Hong Kong government, which they fear would allow China to manipulate the outcome and effectively circumscribe local autonomy. Although these critics do not represent a potent political force in Hong Kong, they reflect the concerns of many of the colony's large middle class.

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Reinforced by China's growing political influence in Hong Kong and the proliferation of Chinese-owned companies, these concerns have triggered a steady emigration of skilled technicians and professionals who are vital to the economy. Both local and international firms have stressed that the availability of professionals will figure prominently in their decisions to stay in or leave Hong Kong after 1997. Some banks already report staff turnovers as high as 50 percent, and some companies, such as Union Carbide, have announced plans to relocate.

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We believe Beijing recognizes it must do more to reassure Hong Kong's business and professional classes of its commitment to autonomy. We expect Beijing will seek to accommodate critics of the Basic Law and to crack down on corrupt activities of the growing number of Chinese companies operating in Hong Kong. The British also will continue to work

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quietly behind the scenes to bolster confidence in Hong Kong's economy and future under Chinese sovereignty. Under these circumstances, Hong Kong can probably maintain a business-as-usual appearance for several years. [REDACTED]

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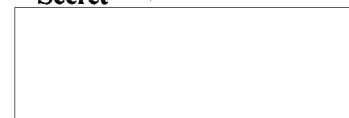
The longer term outlook, however, will remain murky until the early 1990s. For example, we do not know how far Beijing is prepared to go in granting local autonomy or even whether its efforts will make much difference given Hong Kong residents' distrust of Chinese sincerity. Halfhearted Chinese confidence-building measures would worsen the brain drain, contributing not only to a general economic slowdown but also to a serious erosion in Hong Kong's ability to provide the financial, communications, and transportation services that make it an attractive international financial center. [REDACTED]

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The business climate in Hong Kong also will remain sensitive to events in China. We believe that Hong Kong businessmen will watch closely to see whether the Chinese leadership's recent decision to shelve price reform represents a retreat from the reform program or only a temporary pause. A continued strong commitment to market reforms and the open door would have a reassuring effect. Alternatively, a clear loss of reform momentum or, worse, the reversal of some key reform policies would in our view reinforce doubts in Hong Kong about the constancy of Beijing's policy toward the colony. Finally, a smooth transfer of power from Deng Xiaoping—who is widely regarded as the guarantor of Hong Kong's autonomy—is required to demonstrate that a successor can and will abide by the 1984 Sino-British accord. [REDACTED]

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Figure 1
Hong Kong and South China



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**Hong Kong: Looking
Toward 1997****Status of the Agreement**

Beijing and London have made considerable progress over the past four years toward implementing the 1984 Sino-British Joint Declaration. The Sino-British Joint Liaison Group,¹ formed to iron out technical details during the transition to 1997, has already agreed on:

- Hong Kong's continued participation in several international organizations such as GATT, the Asian Development Bank, and the International Labor Organization.
- The development of new travel documents for Hong Kong residents.
- Several air services agreements.
- Pension plans for civil service employees.

The two sides, however, have yet to resolve the question of how much autonomy Beijing will allow Hong Kong after 1997, when it becomes a Special Administrative Region (SAR). This is supposed to be spelled out in the Basic Law, a miniconstitution, a draft of which Beijing made public last April. A long, complex document, the draft attempts to address a number of issues relevant to the turnover of power including the formation of the first government of the SAR, the relationship of the region to the central government, the laws applicable to the region, and the legal rights of the populace.

To keep China's promise to involve the public in the drafting process, a Basic Law Consultative Committee (BLCC)—an advisory group of Hong Kong and mainland Chinese selected by Beijing—canvassed public opinion in Hong Kong this summer. Several officials from both London and Beijing—including Chinese Vice Premier Tian Jiyun, the Director of the Hong Kong and Macau Affairs Office under the State Council Ji Pengfei, and British Foreign Secretary Geoffrey Howe—paid high-profile visits to Hong

¹ In July the Joint Liaison Group moved its permanent base of operations to Hong Kong. The group's three annual plenary meetings will continue to rotate sites among Beijing, London, and Hong Kong.

Kong in the past few months to underscore their commitment to the consultations of this committee.

Cooperation Enhancing Stability

We believe the ability of the British and Chinese to work together has helped in the short run to foster a climate for rapid economic growth and has done much to maintain public order. The British in particular appear determined to keep relations with Beijing smooth and to work quietly to iron out troublesome issues that could undermine public confidence. British officials in London have confided to US Embassy officers, for example, that the Hong Kong Government is having more say than anticipated in the drafting of the Basic Law through Governor David Wilson's regular visits to Beijing and through the Hong Kong Executive Council members on the drafting committee. Because the British must take a hands-off posture toward the Basic Law publicly, Wilson is careful always to have a pretext for his Beijing visits and to balance them with equally frequent consultations in London. Hong Kong Government officials urged civil servants to express opinions on the Basic Law draft during the consultative period, but in a private capacity as individuals, according to Hong Kong Consulate reporting.

London is trying to work out arrangements for the first post-1997 government that will ensure a continuity in policy and bolster confidence. To avoid lame-duck status in its final years of governing, Britain has proposed the idea of a "through-train" legislature—the reappointment by Beijing of Hong Kong's legislative councilors to serve in the new SAR government after 1997. Although China has rejected this idea publicly, a Hong Kong Government official told US Consulate officers that Governor Wilson attained agreement from Beijing during his November 1988 visit to allow legislative councilors elected in 1995 to

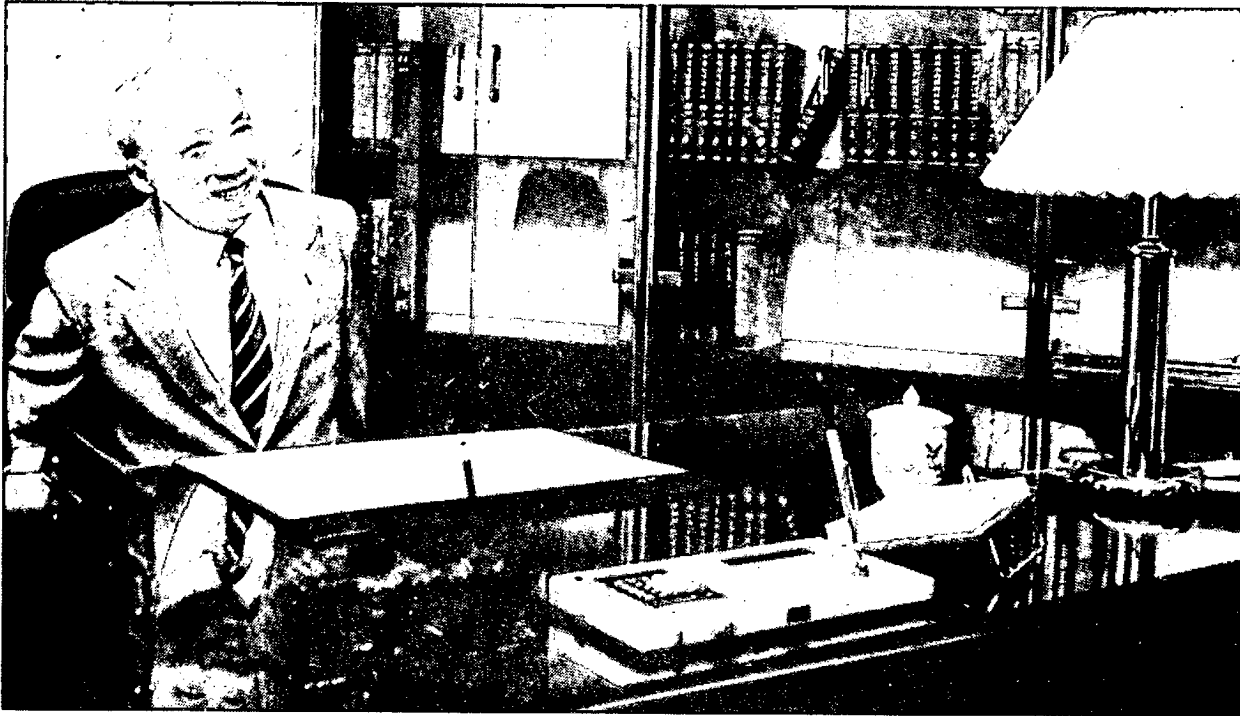


Figure 2. The leader of the Chinese side of the Joint Liaison Group, Ke Zaishuo, in his new office in Hong Kong

serve four-year terms—thereby bridging the 1997 transition. In return, London has offered to allow Beijing to select or approve Hong Kong Government appointments before 1997. The timing remains to be worked out, however, with Beijing's demanding immediate approval power and with London's hoping to postpone such consultations until at least 1993.

China, in turn, has grown more aware of the need to appear responsive to the Hong Kong populace, working hard, for example, to meet its deadline for releasing the first draft of the Basic Law.

British officials also have commented in private that they believe the Chinese are becoming more adept at dealing with Hong Kong matters. Beijing is learning how easily statements or actions can be misunderstood and send

shock waves through the territory. Hong Kong Chief Secretary David Ford told members of the American Chamber of Commerce in Hong Kong that he believed Beijing has gone from "being clumsy, to say the least" to exhibiting greater sensitivity by agreeing, for example, to debates on the Basic Law in both Legco and Britain's Parliament.

Consolidating Economic Ties

The expansion of economic ties between Hong Kong and China—an outgrowth of both the Joint Declaration and reform on the mainland—have contributed to the boom and bullish attitude of many Hong Kong businessmen. Hong Kong is now China's largest export market, importing goods worth \$15 billion last year, up by half from 1986. The US Consulate in Hong Kong estimates that China, through directly or indirectly controlled entities, also has invested about US \$10 billion in the territory, making it the territory's largest foreign investor. Estimates of the number of Chinese-owned companies in Hong Kong range

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Key Provisions of the 1984 Joint Declaration

The policies set out in the Joint Declaration and in the annexes were to form a basis for the Basic Law. Under the agreement:

- *Hong Kong will enjoy a high degree of autonomy as a Special Administrative Region (SAR) of the People's Republic of China, except in foreign and defense affairs, which are the responsibilities of the Central People's Government. Socialist policies applied in the mainland will not be applied to the SAR.*
- *The people of Hong Kong will continue to enjoy their existing rights and freedoms under Hong Kong law. The international covenant on civil and political rights and the international covenant on economic, social, and cultural rights will continue to be applied to Hong Kong. Private property, ownership of enterprises, legitimate right of inheritance, and foreign investment will be protected by law.*
- *The legislature of the SAR will make laws for Hong Kong. The legislature will be elected (how they will be elected is not specified), and the executive will be accountable to the legislature and to the courts.*
- *The government of the SAR will be composed of local inhabitants. Beijing will appoint the chief executive on the basis of an election or after consultations with local authorities. Beijing will*

also appoint principal officials on the recommendation of the chief executive of the SAR.

- *Hong Kong's legal and judicial systems, including the common law, will be maintained. A court of final appeal will be established. The maintenance of public order will be the responsibility of the government of the SAR.*
- *The SAR will be able to negotiate agreements and participate in international organizations in appropriate fields. The SAR will have autonomy in economic, financial, and monetary fields. There will be no exchange control, and the Hong Kong dollar will continue to be freely convertible. Investors will be able to deposit or withdraw their capital freely. The SAR will retain the status of a free port and a separate customs territory.*
- *The SAR will have independent finances. The Central People's Government will not levy taxes on the SAR.*
- *Existing land rights will be recognized. The Hong Kong Government will be able to grant new leases extending until the year 2047.*
- *The right of free entry into and exit from Hong Kong will be guaranteed. The agreement sets out the criteria for the right of abode in Hong Kong and the issuance and use of passports and other travel documents.*

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between 2,000 and 4,000—up from only 300 in 1984, according to the Hong Kong Consulate and press reports.

At the same time Hong Kong is becoming an important economic player in China. According to Hong Kong Consulate reporting, of some 7,800 enterprises with foreign interests in China, about 6,600 are Hong Kong firms. China imported \$8.5 billion in goods from Hong Kong last year, or about one-fifth of

China's imports. China also earns about one-third of its foreign exchange through Hong Kong by direct sales to Hong Kong, reexports through Hong Kong, or remittances and investments. Beijing also looks to Hong Kong for both management and marketing experience and uses its firms there as an educational laboratory for learning Western business practices.

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Hong Kong's Economy: Business as Usual

Hong Kong's uncertain status has not slowed its economic growth. Following sluggishness in 1985, the Hong Kong economy rebounded sharply in 1986, and over the last two years has experienced double-digit growth—13.6 percent in 1987. Strong demand for Hong Kong products in overseas markets as well as the price competitiveness of the territory's exports vis-a-vis most major currencies, except the US dollar, accounted for most of the spectacular export performance last year. The Hong Kong Consulate predicts strong growth in 1988—between 7 and 10 percent—barring any major downturns in world markets.

[REDACTED]

On the negative side, Hong Kong faces rising labor shortages. According to Hong Kong press, there are more than 150,000 vacancies in the construction, manufacturing, restaurant, and hotel industries. Although many manufacturers have moved their operations to southern China to take advantage of surplus labor, others cannot. For example, garment manufacturers cite country-of-origin restrictions as an obstacle to moving across the border, and construction, restaurants, and hotels need labor inside the territory. Some industries are pushing the government to import labor from China, a move the government is considering in addition to allowing some of the Vietnamese refugees in closed camps to work. Emigration by professionals also is aggravating the shortage of personnel in midlevel positions. The labor shortage is pushing up wage and salary levels and contributing, along with higher import prices, to inflation.

[REDACTED]

The boom in China's trade with Hong Kong, especially in the last two years, is mainly attributable to the rapid growth of export-processing industries in the Pearl River Delta area in Guangdong Province. Most of the products processed there are exported via Hong Kong and, according to Chinese press, some 20 percent of Hong Kong's smaller industrial enterprises have economic ties to the area. Many Hong Kong



Figure 3. Governor Sir David Wilson and the Director of the Hong Kong branch of the New China News Agency, Xu Jiatun, at a New Year's reception in early 1988

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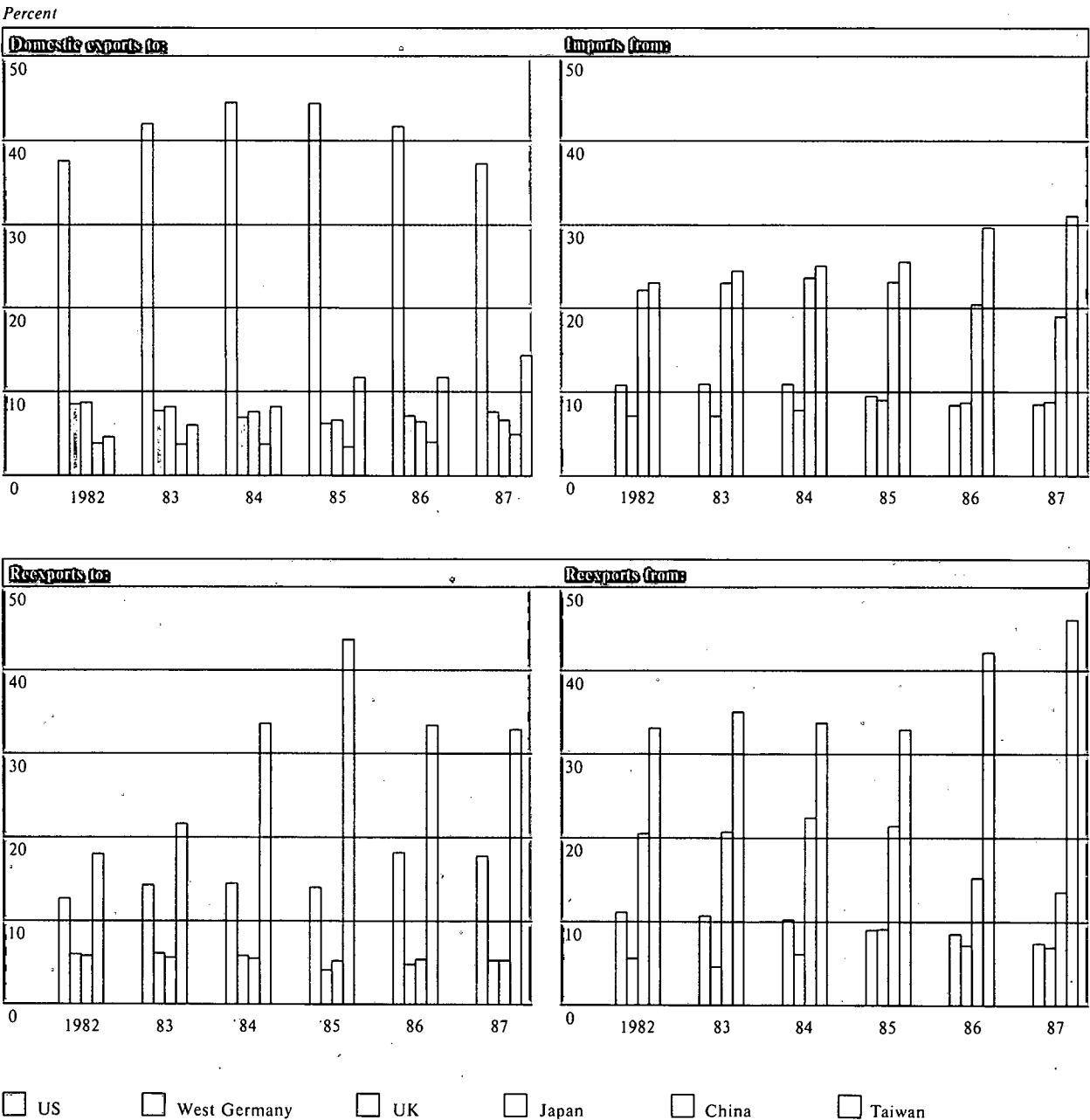
manufacturers have set up labor-intensive factories in Guangdong to take advantage of lower labor costs and because of labor shortages in the territory. Some wealthy Hong Kong businessmen are even investing large sums in the area's infrastructure. For example, Hong Kong tycoon Gordon Wu's Hopewell Holdings is building a US \$1 billion superhighway in Guangdong. Hong Kong's presence has so permeated southern China that in the Shenzhen Special Economic Zone, for example, restaurants, hotels, and taxis accept Hong Kong dollars, and clocks there are set at Hong Kong rather than Beijing time.

[REDACTED]

South China-Hong Kong economic ties provide Beijing with a stake in the city's continued economic vitality. Beijing hopes Hong Kong investors will contribute to its new coastal export-led growth strategy in

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Figure 4
Hong Kong's Major Trading Partners, 1982-87



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particular. In a recent article in China's new theoretical journal *Seeking Truth*,² Xu Jiatur, the head of the New China News Agency (NCNA)—Beijing's de facto diplomatic representative in Hong Kong—urged coastal areas to use the timely economic information on international markets available in Hong Kong in policymaking; pointed out that, as a world financial center, Hong Kong can provide more foreign funds for coastal area development; stated that Hong Kong is an ideal place to set up a sales network for more Chinese exports and aid in developing international markets; and said that Hong Kong could help train foreign trade and management personnel [redacted]

The Clouds on the Horizon

The longer term prospects for stability in Hong Kong, nonetheless, remain uncertain. Although we have no firm figures on the amount of investment in Hong Kong, [redacted] many companies are hedging their bets by investing only in projects that provide a quick (four-to-five-year) return. He asserts that few companies are investing in long-term capital intensive and high-tech industries essential for Hong Kong to retain a competitive position in the international marketplace in a decade.

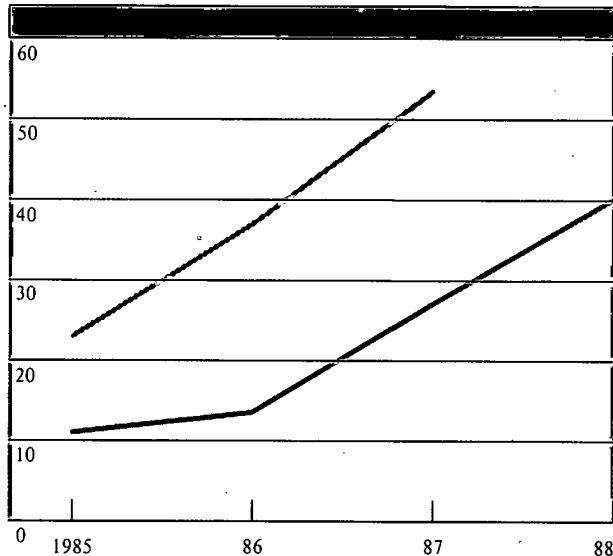
[redacted] many of Hong Kong's largest companies will be making important investment decisions in the early-to-middle 1990s that will have a critical impact on the city's economy beyond 1997. We believe these decisions will be strongly influenced by the steps Beijing and London take in the next year or two to convince the business community that the territory can remain profitable. Among the factors businessmen insist must be retained to preserve Hong Kong's attraction are:

- Low tax rates.
- Convenient transportation and sophisticated communications.
- Easy access to capital and financial services.
- Beneficial profit-remittance policies.
- Large pool of skilled labor [redacted]

² In July the Chinese Communist Party's flagship newspaper *Red Flag* was replaced by the more reform-minded paper *Qiushi*, or *Seeking Truth*. [redacted]

Figure 5
Emigration From Hong Kong,
1985-87^a

Thousands



— Requests for Certificates of No Criminal Conviction
- - - Hong Kong Government Estimate of Emigration

^a Although the Hong Kong Government does not keep official statistics on emigration, the steady rise in requests for certificates of no criminal conviction—a prerequisite for applying to emigrate—indicates emigration from Hong Kong is climbing. We believe the actual number of people leaving Hong Kong is higher than government estimates but somewhat lower than the number of certificates issued.

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Hong Kong is already suffering a brain drain as many people, distrustful of Chinese promises of autonomy, have begun to leave. The Hong Kong Government estimates that more than 27,000 people left Hong Kong last year, many of them midlevel managers and professionals, and that more than 40,000 may leave this year. Some companies, unable to replace their managers, are pulling out. Union Carbide recently

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announced plans to move its regional headquarters to Singapore because of increasing difficulty retaining local senior staff. Other companies have indicated privately they are weighing the advantages and disadvantages of remaining in Hong Kong. [redacted]

The banking industry probably has been hardest hit. One major US bank and the Bank of Tokyo each lost 25 percent of their employees last year, according to Hong Kong Consulate reporting, and several smaller banks reported staff turnovers as high as 50 percent. A continuation of this trend could eventually force some banks to streamline operations or relocate some activities to other countries in the region. The Banque Nationale de Paris already closed one of its profitable branches after it was unable to find replacements for managers who emigrated. [redacted]

The Hong Kong civil service could also be seriously affected if the brain drain continues, although the Hong Kong Government denies any problems. One senior official asserted that the government's localization program—a policy to replace expatriate personnel with Hong Kong Chinese—is faltering because of a shortage of qualified locals: according to figures from Hong Kong's Census and Statistics Department, there were more than 7,500 vacancies at the end of 1987. Hong Kong police force officials also acknowledge that they may face a manpower shortage because of the difficulty in recruiting overseas and a preference among local people to work in private companies, which offer more opportunity to emigrate. In the last two years Hong Kong's fire department also reportedly lost 10 percent of its officials—all ethnic Chinese who emigrated. [redacted]

In May Hong Kong announced the formation of a task force to study the problem and to improve the gathering of emigration statistics. According to the US Consulate in Hong Kong, a group of Hong Kong businessmen have also commissioned a firm to conduct a yearlong study of the economic problems confronting the territory, including emigration. Given the potential problems that continued emigration may create for both the government and businesses, the Hong Kong Government is investigating ways to coordinate programs with the private sector to induce Hong Kong professionals to stay or return to the

territory. Whatever the findings, senior Hong Kong Government officials have repeatedly stressed they will not try to stop emigration by means of controls or by exerting pressure on other countries. [redacted]

The Challenge for the Chinese

How constructively Beijing deals over the next three to five years with business and public concerns will, in our judgment, have an important impact on Hong Kong's long-term outlook. Although the Chinese have shown increased flexibility and adeptness, many people continue to believe that Beijing could renege after 1997 on whatever promises it makes now, according to a recent Hong Kong poll. Chinese willingness under the Basic Law to ensure the independence of the local judiciary, to incorporate concrete guarantees of civil liberties, and to allow Hong Kong citizens to maintain dual nationality could allay the fears of many of Hong Kong's large middle class. Whether Beijing is prepared to make such concessions should become apparent once a revised version of the Basic Law is resubmitted for public scrutiny sometime in 1989. The Basic Law Drafting Committee (BLDC) is slated to reconvene in January 1989 to make revisions in the draft based on the summer 1988 public consultations. [redacted]

Much of the criticism has focused on the lack of adequate guarantees to protect basic civil liberties and to prevent Beijing from arbitrarily interfering in Hong Kong's affairs. Prodemocratic groups have been particularly critical of the options set forth for selecting the future Special Administrative Region government. Although Beijing has not stated a preference publicly, the "Group of 88"—a group of conservative businessmen, many of whom were appointed to the BLCC by Beijing—favor a proposal to establish an electoral college to select the chief executive and a portion of the legislature. Liberal groups oppose such a body because they fear China would try to manipulate and control its members. [redacted]

We believe Beijing also must do more to dampen fears that its growing political and economic influence in the colony will undermine Hong Kong's autonomy. In

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Prodemocracy Pressure Groups: Nascent Political Parties?

Although Hong Kong does not have any official political parties, in the last few years a number of political pressure groups have formed to push for democratic reforms and were behind a signature campaign last fall to garner support for direct elections to Hong Kong's legislature this year. Despite such efforts, these groups were unable to exert much pressure on the Hong Kong Government to reverse its decision to postpone direct elections until 1991. Three of the most influential prodemocracy groups—Meeting Point, the Hong Kong Affairs Society, and the Hong Kong Association for Democracy and People's Livelihood—had more success when they banded together to support each other's candidates for District Board seats in March 1988. The US Consulate in Hong Kong estimates that out of 264 available seats on the District Boards, about 61 core members of the democratic alliance and perhaps an additional 30 to 40 sympathizers won seats.

Not tied to any particular group but probably the best known supporter of democratic reforms is Legislative Councilor Martin Lee. Lee, also a member of both the BLDC and the BLCC, has been outspoken in his support for direct elections. Lee led a delegation of democratic group leaders to London last December to lobby the British Government to support direct elections in 1988 and also visited the United States last spring seeking US support for democratic change in the territory

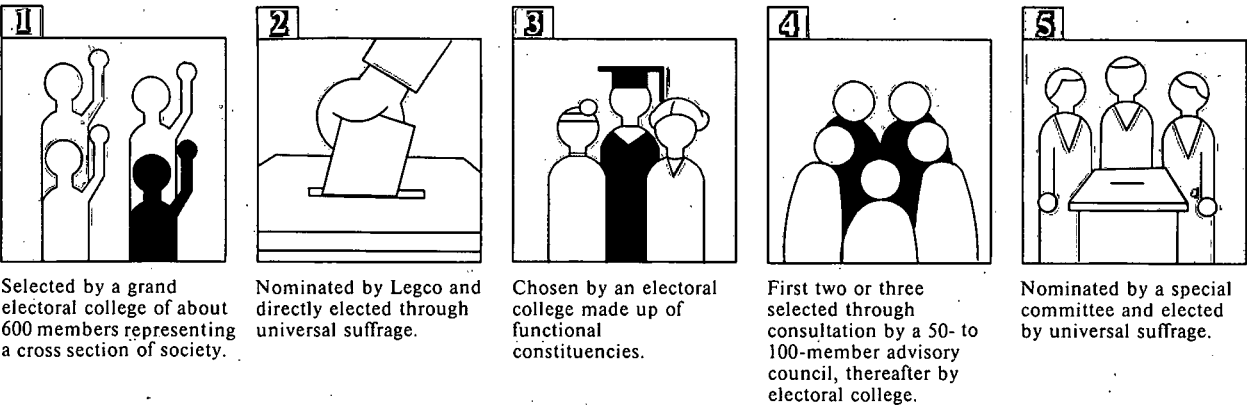
Since the release of the draft of the Basic Law, the pressure group Meeting Point has led a coalition known as the Group of 190 in a fight against a proposal made by conservative Hong Kong businessmen to form an electoral college to select the first government of Hong Kong after 1997. The conservatives have formed their own pressure group called the "Group of 88," which does not want to see the introduction of party politics into Hong Kong. They fear this will cause instability and place power in the hands of those who would increase taxes and social and welfare services, thereby cutting into their profits. Ironically, this stance against political reforms by many of Hong Kong's richest elites has made them allies with Beijing



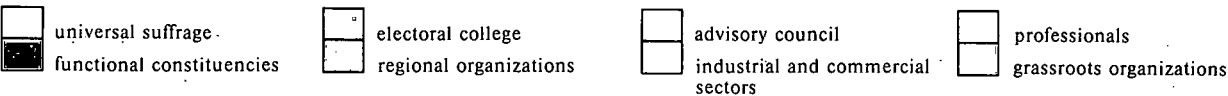
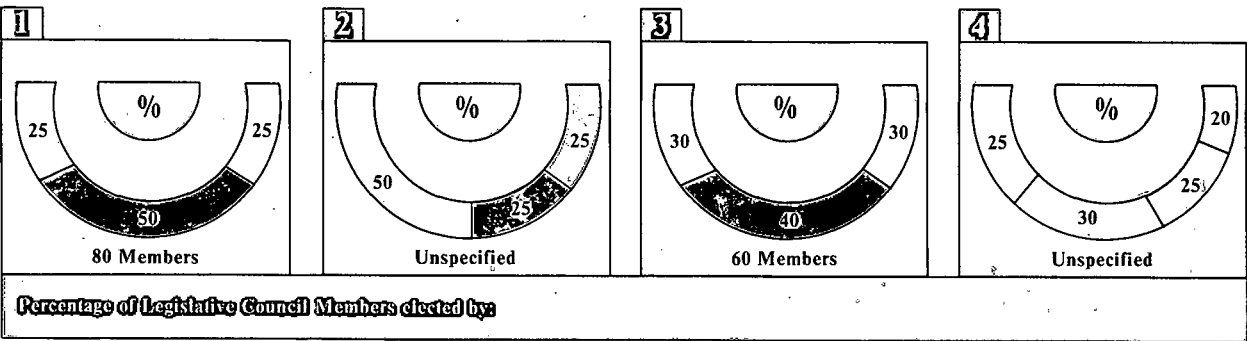
Figure 6. Protesters during a September 1988 prodemocracy rally hold up a banner calling for a democratic Basic Law.

Figure 7
Options for Choosing Hong Kong's Chief Executive
and Legislature

☐ **Five Options for Choosing Hong Kong's Chief Executive**



☐ **Four Options for the Composition of Hong Kong's Legislature**



Key Issues in the Basic Law

Critics have cited clauses in the draft of the Basic Law that they believe violate the principles of the Sino-British Joint Declaration or are worded so vaguely that they fear Beijing may twist the meaning. Among the problems are the following issues. [redacted]

Interpretation of the Basic Law. The draft gives the Standing Committee of China's National People's Congress the power to interpret the Basic Law and to review laws enacted by the future Hong Kong Special Administrative Region (SAR). Critics argue that this takes away Hong Kong's judicial independence—the Joint Declaration stipulated that Hong Kong would have the final court of appeal. They are calling for drafters to qualify the Standing Committee's power and outline the procedures for proposing amendments to the Basic Law to include consultation with Hong Kong's chief executive, legislature, and a Basic Law committee. [redacted]

Formation of the First SAR Government. The Joint Declaration was vague on the details of the political structure and the formation of the first SAR government, and the Basic Law draft does little clarifying. The draft presents a series of options for selecting the first chief executive and legislature (see figure 7). Some critics say the inclusion of several different options for the selection of the SAR's government may allow Beijing to manipulate public opinion. London has advocated a transitional government allowing those Legco members elected before 1997 to serve out their terms, but Beijing believes the retention of officials who served under the British would impinge on its sovereignty. [redacted]

Political and Civil Rights. Critics fear the stipulation in the draft that the SAR shall prohibit by law any act designed to undermine national unity or subvert the Central People's Government is too vague and provides inadequate safeguards for individual freedoms. Both Legco and Amnesty International have suggested that drafters remodel the guarantees of civil rights in the draft after two UN international covenants on international human rights standards. [redacted]

Economic Policies. Critics assert the draft of the Basic Law goes too far by constitutionalizing micro-level economic policies—such as proscribing a low tax policy and balanced budget. Governor Wilson criticized these provisions in a speech before British businessmen in London in June, stating they “would limit the flexibility of the Hong Kong SAR and would tend to restrict the autonomy promised in the Joint Declaration.” Sources of the Hong Kong Consulate suggest that these provisions may have been inspired by influential Hong Kong business elites and that ranking Chinese members of the BLDC also believe them unnecessarily restrictive. [redacted]

Dual Nationality. Legco and local groups are pressing for Chinese recognition of dual nationality and for provisions in the draft allowing dual nationals to serve in senior government positions in the SAR. They believe the stipulation giving only permanent residents of the SAR the right to vote, stand for election, and hold senior government posts will deny a stake to foreign nationals and Hong Kong Chinese holding other passports—and may discourage those now emigrating from Hong Kong from returning. [redacted]

Official English Version. Although Beijing has said there will be an official English version of the Basic Law, Chinese officials have said that the Chinese version will be used in any disputes. Many believe that an authoritative English version of the Basic Law is needed to preserve Hong Kong's international business status and its legal system based on English common law. [redacted]

Basic Law Committee. Controversy also surrounds the formation, members, and status of the Basic Law committee after 1997. The committee is to be the key advisory body to the National People's Congress Standing Committee on crucial Basic Law issues. [redacted]

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July 1988, as stipulated by the 1984 Joint Declaration, both the British and Chinese teams of the Joint Liaison Group established permanent offices in the territory. Added to the NCNA office—often regarded as a shadow government—this new Chinese office greatly increased Beijing's official presence. British team officials told US Consulate officers that their Chinese counterparts have shown a keen interest in monitoring the activities of the Hong Kong Government, and the British worry that perceived interference by the Chinese may affect local confidence. The presence of the new Chinese team office may also result in conflicts between the different Chinese bodies involved in implementing Beijing's Hong Kong policies (see appendix A).

Beijing's attempts to manipulate events also contribute to doubts about Chinese sincerity. Chinese cadres, through "united front work," have sought to use the press, labor unions, and prominent figures to influence public opinion on political reform and the Basic Law:

- We believe Beijing manipulated the results of the Hong Kong Government's political reform survey last fall by encouraging its organizations in Hong Kong to oppose direct elections. The US Consulate in Hong Kong, for example, obtained a form that the pro-Beijing Federation of Trade Unions circulated to its members to sign opposing direct elections.
- NCNA Hong Kong has been fairly successful in intimidating local newspapers—according to Hong Kong Consulate reporting, Hong Kong papers engage in increasing self-censorship. NCNA officials also meet with local newspaper owners to influence editorial lines, [redacted] and even indirectly pay subsidies to some editors.
- We believe Beijing is encouraging leftist trade unions to take on a larger role in Hong Kong politics by establishing additional unions to increase their representation on the Labor Advisory Board and the

Legislative Council.³ Beijing also plans to set up ostensibly neutral labor unions for those who are sensitive about associating with pro-Beijing trade unions.

- We believe Beijing also has co-opted selected Hong Kong businessmen by appointing them to the National People's Congress, the Chinese People's Political Consultative Conference, the BLDC, and the BLCC. [redacted]

Even more disturbing to some businessmen has been the explosion of ministerial, provincial, and individually owned mainland companies in Hong Kong. These are proliferating so fast we believe Beijing has lost control over them, prompting Hong Kong businessmen to complain that these companies are taking advantage of their Chinese financial backing to drive them out of business. Some Western and local bankers also are concerned about the quality of loans made by the Chinese banks in Hong Kong in the manufacturing and other sectors, according to Hong Kong Consulate reporting. Companies claiming affiliations with China have gained financial support in spite of their sometimes unimpressive financial performance and limited equity. [redacted]

In an apparent reponse to the growing criticism, Xu Jiatur announced on 10 June that the NCNA Hong Kong's economic department is investigating China-backed firms. On 15 June, Lu Ping, the Secretary of the State Council's Hong Kong and Macau Affairs Office, speaking to local and foreign businessmen in Hong Kong, also said Beijing would instruct its

³ The 12-member Labor Advisory Board is a nonstatutory body that advises Hong Kong's Commissioner for Labor on all matters pertinent to the interests of the local work force. Although trade unions have not played a major political or economic role in Hong Kong, the board is viewed as a steppingstone for politically oriented labor leaders seeking one of the two seats reserved for labor on Legco. Both the four union board representatives and the two Legco seats are elected on a one-union/one-vote basis. [redacted]

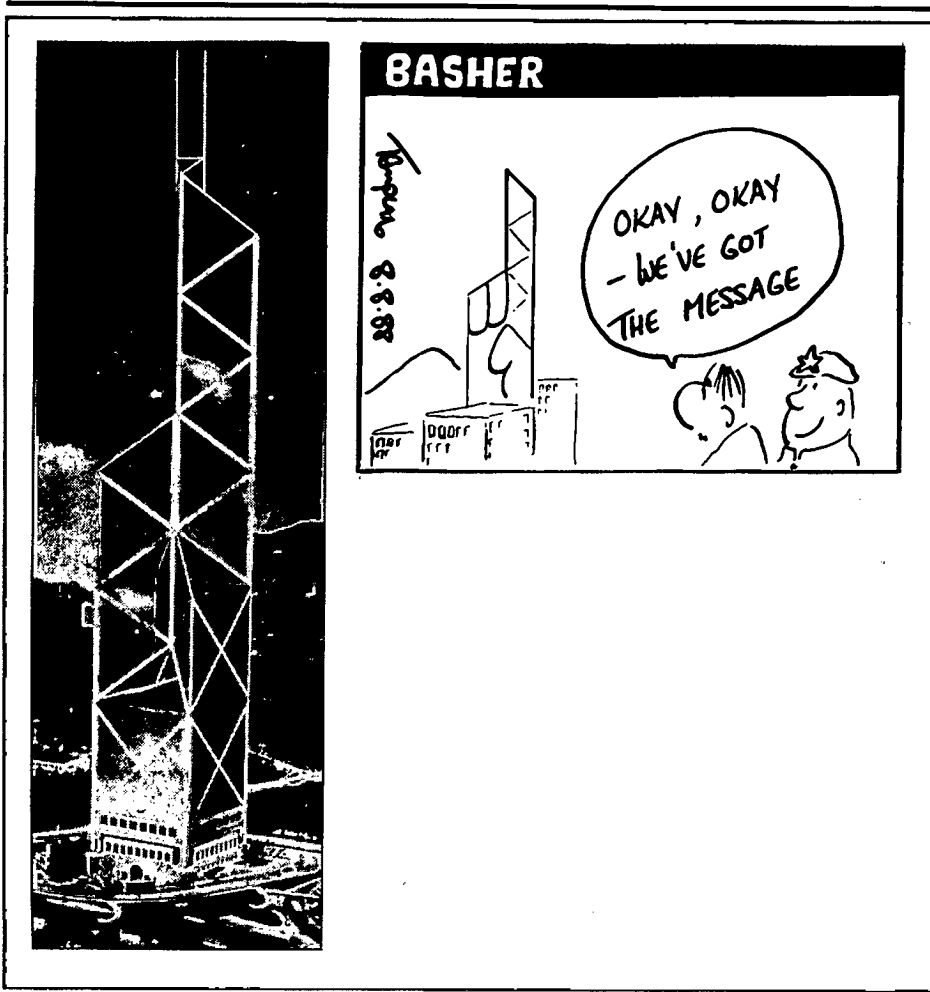


Figure 8. An artist's rendition of the finished Bank of China building and a cartoonist's depiction. The new building dwarfs the recently built Hong Kong Bank headquarters.

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enterprises in Hong Kong to conform to Hong Kong business practices. In early June, Beijing sent a team to study the activities of mainland firms, and Hong Kong press reports that Beijing plans to set up an entity to monitor Chinese enterprises—an unattainable goal, in our view. Beijing's continuing crackdown on corruption on the mainland is also spilling over into Hong Kong.

Looking Toward 1997

We believe Hong Kong will retain an appearance of business as usual at least through the early 1990s. Because most Hong Kong-based businesses believe

there is still time to make money before the territory reverts to China, we expect the economy to continue to do well. Some Hong Kong Chinese businessmen, who have invested heavily on the mainland, probably have decided to stay. But we suspect that many more companies remain undecided and will continue to hedge their bets by investing mainly in projects promising a fast turnaround on their money so they can pull out quickly if they judge that the costs and risks of remaining outweigh the advantages.

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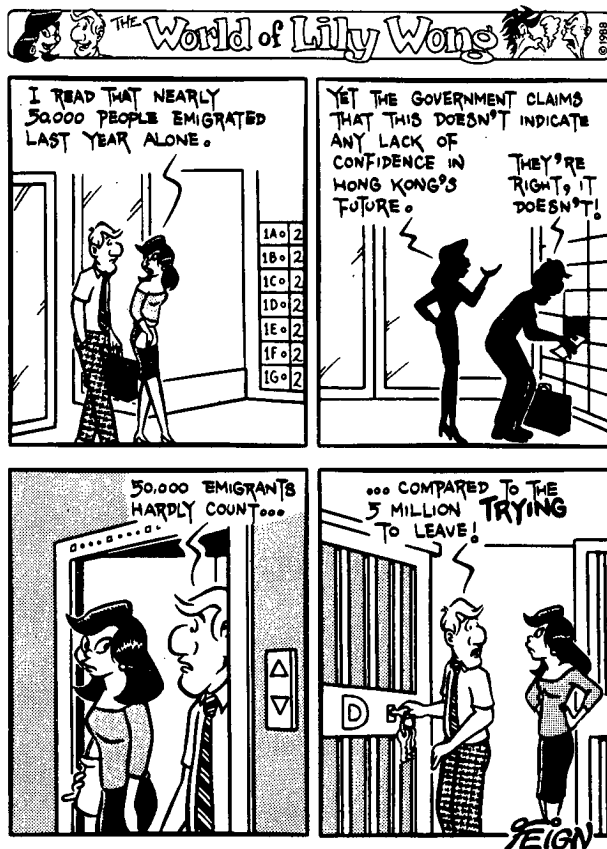


Figure 9. A favorite topic of political cartoonists in Hong Kong has been emigration from the colony.

Beijing will probably offer inducements to firms to stay and will take disciplinary action against some companies to demonstrate its commitment to free competition. Similarly, we expect Beijing to try to keep the emigration of critically needed professionals and technicians within manageable limits by accommodating at least some key concerns over the Basic Law. London, in turn, probably will try to bolster confidence by promoting large economic projects such as a new airport and improved port facilities.

Nonetheless, we doubt that the key imponderables in Hong Kong's longer term outlook will become clearer soon. For example, we cannot predict how far Beijing is prepared to go in granting local autonomy or even whether such efforts will make much difference given

the depth of distrust of China in Hong Kong. It is clear that halfhearted Chinese confidence-building measures will worsen the brain drain, undercutting Hong Kong's ability to provide the financial, communications, and transportation services that make it an attractive international financial center and forcing many companies to relocate by the mid-1990s.

Events in China also will heavily influence the business climate in Hong Kong. We believe Hong Kong businessmen will be closely watching whether the Chinese leadership's decision to shelve price reform represents a retreat from market reforms or only a temporary pause to get the mainland economy under better control. A continued strong commitment to the open door and market reforms would be reassuring. A clear loss of reform momentum or, worse, a reversal of some key reform policies would in our judgment reinforce deep-seated doubts about the constancy of Beijing's policy toward the territory.

Finally, a smooth transfer of power from Deng Xiaoping—almost inevitable by the early 1990s—will be important. As the architect of the “one country—two system” formula, Deng is regarded by many in Hong Kong as the guarantor of their future. It will be Deng's successor—General Secretary Zhao Ziyang or someone else—who will have to demonstrate that he can and will abide by Beijing's commitment to the 1984 accord and Deng's promise to maintain Hong Kong's social and economic systems for at least the next 50 years.

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Appendix A

Beijing's Groups Overseeing Hong Kong Policies

Our information on China's decisionmaking processes and implementation of policies toward Hong Kong is sketchy. Beijing deliberately keeps the profile of the Chinese Communist Party (CCP) in Hong Kong low to avoid heightening suspicions of China's intentions. Although the official cadre presence in Hong Kong continues to grow and is estimated to be over 5,000, much of the workings of the party and government offices remains shrouded, in contrast to the open proliferation of Chinese economic entities. [redacted]

Almost all of China's major policy decisions are made by small "leading groups" of top CCP officials. According to sources of one Hong Kong paper, the CCP group on Taiwan, Hong Kong, and Macau is headed by Chinese President Yang Shangkun, who has "an overriding say" in decisions affecting the territory. Deng Xiaoping reportedly is the only higher authority; State Council Hong Kong and Macau Affairs Office Director Ji Pengfei and Xu Jiatun, head of the New China News Agency's Hong Kong office, also belong to this group [redacted]

We believe NCNA Director Xu Jiatun, whose statements and actions in the territory have earned him the nickname of Hong Kong's "shadow governor," is primarily responsible for carrying out Beijing's policies. NCNA Hong Kong acts both as a news agency and as a channel for handling diplomatic and commercial matters between the Hong Kong Government and Beijing, and even occasionally deals with countries without formal diplomatic ties to China such as South Korea. In 1985, Xu reorganized NCNA along the lines of government departments, giving it the appearance of a shadow government. We believe that NCNA officials are expanding their contacts at all levels in Hong Kong— [redacted]

Because Xu also heads the Hong Kong Macau Work Committee—the central body of the CCP in Hong Kong—the distinction between NCNA and the committee is easily blurred. Members of the committee

include key NCNA officials and leaders of the major Chinese organizations in Hong Kong such as China Resources, the Bank of China, and the China Merchants Steam Navigation Company, as well as representatives from pro-Beijing labor, media, and education entities. The committee engages heavily in united front work in education, political, labor, and media circles—probably often under the cover of NCNA. It is also a conduit for passing guidance from Beijing to the party apparatus of Chinese organizations in Hong Kong. [redacted]

NCNA Hong Kong is subordinate to China's State Council, which has its own organization dealing with Hong Kong affairs. Veteran CCP official and former Foreign Minister Ji Pengfei heads the Council's Hong Kong and Macau Affairs Office. In 1985 the office set up the Hong Kong and Macau Research Institute, a think tank to provide Chinese leaders with background on a wide range of issues for working out policies in Hong Kong and Macau. Also in 1985, Beijing established a second Hong Kong and Macau Affairs Office, but this one is directly subordinate to the Foreign Ministry and headed by Ke Zaishuo—also the leader of the Chinese Joint Liaison Group team. Although there is little information to allow us to differentiate between the duties and functions of the two Hong Kong and Macau Affairs Offices, we believe the State Council is more concerned with policymaking and direction and probably relegates the handling of day-to-day matters involving the Joint Liaison Group and various subcommittees concerned with the drafting of the Basic Law to the Foreign Ministry office. [redacted]

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Appendix B

The Evolution of Chinese Companies in Hong Kong

Since China embarked on its reform program in 1979, the number and types of Chinese companies in Hong Kong have rapidly expanded. From a few long-established state-controlled companies—China Resources Company, the Bank of China, China Merchants and Steam Navigation Company, and the China Travel Service—China's economic presence in Hong Kong has grown to include organizations representing national, provincial, municipal, military, and private interests numbering between 2,000 and 4,000, according to press and Hong Kong Consulate reporting. The growth of these companies has not been systematic, and many details about their missions, organizations, lines of authority, and even numbers remain unknown.

Among the largest Chinese organizations in Hong Kong are:

- *China Resources Company.* Before 1980, almost all of China's trade through Hong Kong was controlled by the Ministry of Foreign Economic Relations and Trade (MOFERT) through the China Resources Company (CRC). CRC enjoys the position of "big brother" among Chinese commercial entities and the well-established wholesalers and retailers in Hong Kong. In the last few years, because of increased competition from provincial and municipal trade companies, CRC has diversified into other areas, including property, banking, transportation, packaging, and activities to facilitate technology transfer. CRC now operates chains of restaurants, retail shops, and supermarkets in Hong Kong.
- *The Bank of China Group.* The Bank of China is the leading bank in the Bank of China Group (BOCG), which includes 13 sister banks and has a near monopoly on China trade financing in Hong Kong. These banks also hold the major share of small local deposits in Hong Kong and are second only to the Hong Kong and Shanghai Bank in total deposits. Between 1980 and 1985, the BOCG increased its capital by 1,000 percent, raised its loan

portfolio by 600 percent, and now has some 265 branch banks. In 1986 loans to the local manufacturing sector grew by 25 percent, while loans to China-related businesses increased by 50 percent. Little information is available concerning the quality of the BOCG's loan portfolio, but some Western and local bankers question some of BOCG's practices. CRC joined with the Bank of China to buy a 35-percent share of Conic, a loosely structured conglomerate of Hong Kong electronics firms, in a disastrous bailout in 1984. They have sunk an additional \$141 million into the company.

- *China Merchants Steamship Navigation Company.* Owned by China's Ministry of Communications, the China Merchants Steamship Navigation Company (CMSN) has taken advantage of the gradual changes in China's foreign trade system under economic reform. In 1979, Beijing granted CMSN a large measure of autonomy and approved a new development strategy that encouraged the company to diversify. In 1985, CMSN acquired one-quarter of the troubled Far East Bank and, the following year, a controlling share of the Union Bank of Hong Kong. CMSN set up the Shekou industrial zone in Shenzhen and then established the China Merchants Bank in the zone in 1986. CMSN has also expanded into construction, engineering, and off-shore oil-related industries.
- *The China International Trust and Investment Corporation.* Rong Yiren, known as China's red capitalist, formed the China International Trust and Investment Corporation (CITIC) in 1979 primarily to attract foreign investment and technology into China. CITIC has the status of a government ministry and the authority to make its own business decisions and is accountable for its profits and losses. In May 1987, CITIC consolidated its investment in Hong Kong and set up a holding company

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named CITIC Hong Kong (Holdings) Ltd. CITIC Hong Kong has invested in finance, industry, trading, real estate, public utilities, aviation, and shipping, as well as industrial projects and power stations in China, and is involved in joint ventures in both Hong Kong and China. In 1986, CITIC bought out the ailing Ka Wah Bank, and in 1987 it purchased 12.5 percent of Cathay Pacific Airways, the territory's main airline. CITIC is also using its Hong Kong office to develop trade with Taiwan and South Korea.

- *China Everbright Holdings Company.* Everbright was established in 1983 to make well-publicized Chinese investments in Hong Kong and to attract foreign investment to China. Beijing has been disappointed in the performance of both the company and its chairman, Wang Guangying, however. In 1984, Everbright was involved in a highly embarrassing real estate deal that became the subject of an official Hong Kong Government inquiry, and Everbright apparently lost heavily in speculative trading when the Hong Kong stock market crashed in October 1987. [REDACTED]

With the partial decentralization of China's foreign trade system in late 1979, MOFERT and the CRC began to lose their monopoly over Hong Kong-China trade. Many provincial and municipal governments,

as well as some central departments, set up representative trade offices in Hong Kong. Among these new offices, Guangdong and Fujian Province's representatives expanded the most rapidly because of their proximity to Hong Kong and numerous overseas Chinese ties. Almost every province and each of China's four Special Economic Zones and the 14 coastal cities have established offices under the authority of their respective governments. [REDACTED]

Finally, there are hundreds of other Chinese companies operating in Hong Kong without official authorization. Many of these entities are "shell companies," set up by Chinese organizations in Hong Kong to invest in China as foreign investors—thereby obtaining special benefits granted to foreign-invested enterprises in China. Other entities in Hong Kong are there at the initiative of family groups or private interests, usually to make a quick buck. Still other companies are not readily identifiable as Chinese connected and focus on indirect trade with Taiwan or South Korea, facilitating China's acquisition of restricted technology, or serving as middlemen in arms transfers. [REDACTED]

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